

**REPORT ON EXAMINATION
OF THE**

**CLEARWATER INSURANCE COMPANY
AS OF
DECEMBER 31, 2004**

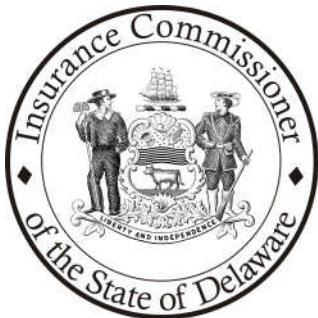
I, Matthew Denn, Insurance Commissioner of the State of Delaware, do hereby certify that the attached REPORT ON EXAMINATION, made as of DECEMBER 31, 2004 of the

CLEARWATER INSURANCE COMPANY

is a true and correct copy of the document filed with this Department.

ATTEST BY: *Antoinette Handy*

DATE: 20 JUNE 2006



In Witness Whereof, I HAVE HEREUNTO SET MY HAND AND AFFIXED THE OFFICIAL SEAL OF THIS DEPARTMENT AT THE CITY OF DOVER, THIS 20TH DAY OF JUNE 2006.

Matthew Denn
Insurance Commissioner

REPORT ON EXAMINATION
OF THE
CLEARWATER INSURANCE COMPANY
AS OF
December 31, 2004

The above captioned Report was completed by examiners of the Delaware Insurance Department.

Consideration has duly been given to the comments, conclusions, and recommendations of the examiners regarding the status of the Company as reflected in the Report.

This Report is hereby accepted, adopted, and filed as an official record of this Department.

A handwritten signature in black ink, appearing to read "Matthew Denn", written over a horizontal line.

MATTHEW DENN
INSURANCE COMMISSIONER

DATED this 20TH Day of JUNE 2006.

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February 22, 2006

SALUTATION

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Honorable Sally McCarty, Commissioner
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Department of Insurance
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Honorable Matthew P. Denn
Insurance Commissioner
State of Delaware
841 Silver Lake Boulevard, Suite 100
Dover, Delaware 19904

Commissioners:

In compliance with instructions and pursuant to statutory provisions contained in Certificate of Authority Number 05.011, an examination has been made of the affairs, financial condition and management of

CLEARWATER INSURANCE COMPANY

hereinafter referred to as "Company" or "Clearwater" incorporated under the laws of the State of Delaware. The examination was conducted at the administrative office of the Company located at 300 First Stamford Place, Stamford, Connecticut. The examination of the Company was conducted concurrently with that of its subsidiary, Hudson Insurance Company (Hudson). Separate reports of examination were filed for each company.

The report of examination thereon is respectfully submitted.

SCOPE OF EXAMINATION

The financial condition examination of the Company, covered the period from January 1, 2003 through December 31, 2004 and consisted of a general survey of the Company's business policies and practices; management, any corporate matters incident thereto; a verification and evaluation of assets and a determination of liabilities. Transactions subsequent to the latter date were reviewed to the extent deemed necessary.

The format of this report is designed to explain the procedures employed on the examination and the text will explain changes wherever made. If necessary, comments and recommendations have been made in those areas in need of correction or improvement. In such cases, these matters were thoroughly discussed with responsible personnel and/or officials during the course of the examination.

The general procedure of the examination followed rules established by the National Association of Insurance Commissioners (NAIC) Committee on Financial Condition Examiners Handbook as adopted by the Delaware Insurance Department under Delaware Insurance Code Section 526, and generally accepted statutory insurance examination standards.

In addition to items noted in this report, the following topics were reviewed and are included in the work papers of this examination:

- Fidelity bond and other corporate insurance
- Corporate records
- NAIC Ratios
- Legal Action
- Schedule of Examination Adjustments
- Subsequent Events

HISTORY

The Company (formerly Skandia America Reinsurance Corporation) was incorporated on May 15, 1974 under the laws of the state of New York. The Company is the successor to the United States Branch of Skandia Insurance Company, Ltd (publ), Stockholm, Sweden, which entered the United States on May 29, 1900.

On May 1, 1978, a Delaware company was incorporated to act as the vehicle for the transfer of the corporate domicile from New York to Delaware. The redomestication was accomplished effective December 31, 1978, by merger of the two companies, with the surviving company adopting the identity of the original company, including its date of incorporation, May 15, 1974.

Fairfax Inc. (a Wyoming Corporation) purchased the Company, and its subsidiary, on May 31, 1996. Effective December 31, 1995 the Company, entered into a stop-loss agreement with Skandia Insurance Company, Ltd. (publ) with an aggregate limit of \$175 million excess of December 31, 1995 loss and lae reserves, subject to an annual aggregate limit of \$17.5 million. During 1999, Skandia Insurance Company assigned its liability to nSpire Re Limited (nSpire Re) (formerly ORC Re Limited) an Irish company. On April 13, 1999, Fairfax purchased the TIG Insurance Group. Included in this Group of companies was the TIG Reinsurance Company. The name of this company was changed to Odyssey America Reinsurance Corporation (a Connecticut company). On September 15, 1999, the Delaware Insurance Department approved the Company's request to realign the companies so that the Company became a subsidiary of Odyssey America Reinsurance Corporation.

On December 3, 2003 Odyssey Reinsurance Corporation changed its name to Clearwater Insurance Company. The name change was to better reflect the change in the Company from a reinsurer to a direct writer. In 1999 the Company stopped accepting new reinsurance business and in 2004 had its first direct premiums written.

CAPITALIZATION

At December 31, 2004, as reported in its annual statement, the Company's authorized capital is \$7,500,000 consisting of 25,000 issued and outstanding shares of common stock at a par value of \$300 per share. The following changes occurred in the capital and surplus accounts since the prior examination.

| | Common Capital Stock | Gross Paid-in and contributed | Unassigned Surplus | Total |
|----------------------|-------------------------|----------------------------------|-----------------------|----------------------|
| December 31, 2002 | \$7,500,000 | \$254,091,672 | \$225,524,028 | \$487,115,700 |
| Operations: (1) | | | | |
| 2003 | | | 69,834,059 | 69,834,059 |
| 2004 (4) | | | (34,046,575) | (34,046,575) |
| Capital changes: (2) | | | | |
| Dividends 2003 (3) | | | (45,000,000) | (45,000,000) |
| Surplus paid-in 2003 | | 45,092,813 | | 45,092,813 |
| Surplus paid-in 2004 | | 60,411,191 | | 60,411,191 |
| December 31, 2004 | <u>\$7,500,000</u> | <u>\$359,595,676</u> | <u>\$216,311,512</u> | <u>\$583,407,188</u> |

1. Operations is defined as Net income, Change in net unrealized capital gains or (losses), Change in net unrealized foreign exchange capital gain (loss), Change in net deferred income tax, Change in nonadmitted assets and change in provision for reinsurance.
2. Capital changes were due to dividends paid to shareholder and surplus contributions by the Company's parent.
3. Dividend in 2003 was an ordinary dividend paid by the Company.
4. The loss from operations in 2004 was the result of losses exceeding previous estimates.

MANAGEMENT AND CONTROL

Pursuant to the General Corporation Law of the State of Delaware as implemented by the Company's Certificate of Incorporation and By-Laws, all corporate powers and its business, property and affairs are managed by or under the direction of its Board of Directors. The Board shall consist of eight members.

The members of the Board of Directors serving as of December 31, 2004, were as follows:

| <u>Director's Name</u> | <u>Principal Business Affiliation</u> |
|----------------------------------|---------------------------------------|
| Andrew Acheson Barnard, Chairman | Hudson Insurance Company |
| Robert Stanley Bennett | Hudson Insurance Company |
| Christopher Liam Gallagher | Hudson Insurance Company |
| James Edward Migliorini | Hudson Insurance Company |
| Donald Lee Smith | Clearwater Insurance Company |
| Charles Dominic Troiano | Clearwater Insurance Company |
| Michael Gerard Wacek | Clearwater Insurance Company |
| Brian David Young | Clearwater Insurance Company |

The Company's By-Laws provide for the Board to designate one or more committees, each committee to consist of one or more of the directors of the corporation. As of December 31, 2004 the Board of Directors had appointed the following committees.

| <u>Investment Committee</u> | <u>Compensation Committee</u> |
|-----------------------------|-------------------------------|
| Andrew A. Barnard | Andrew A. Barnard |
| Michael G. Wacek | Michael G. Wacek |
| Charles D. Troiano | Charles D. Troiano |

| <u>Trustees to Restated Profit Sharing Plan</u> | <u>Benefit Plan Committee</u> |
|---|-------------------------------|
| Andrew A. Barnard | Andrew A. Barnard |
| Donald L. Smith | Donald L. Smith |
| Michael G. Wacek | Michael G. Wacek |

None of the above committees held meetings evidenced by minutes.

Clearwater Insurance Company

The By-Laws of the Company provide for a President, one or more Vice Presidents, one or more Secretaries, and such other officers, if any, as may be designated by the Board of Directors. At December 31, 2004 the Company's principal officers and their respective titles are as follows:

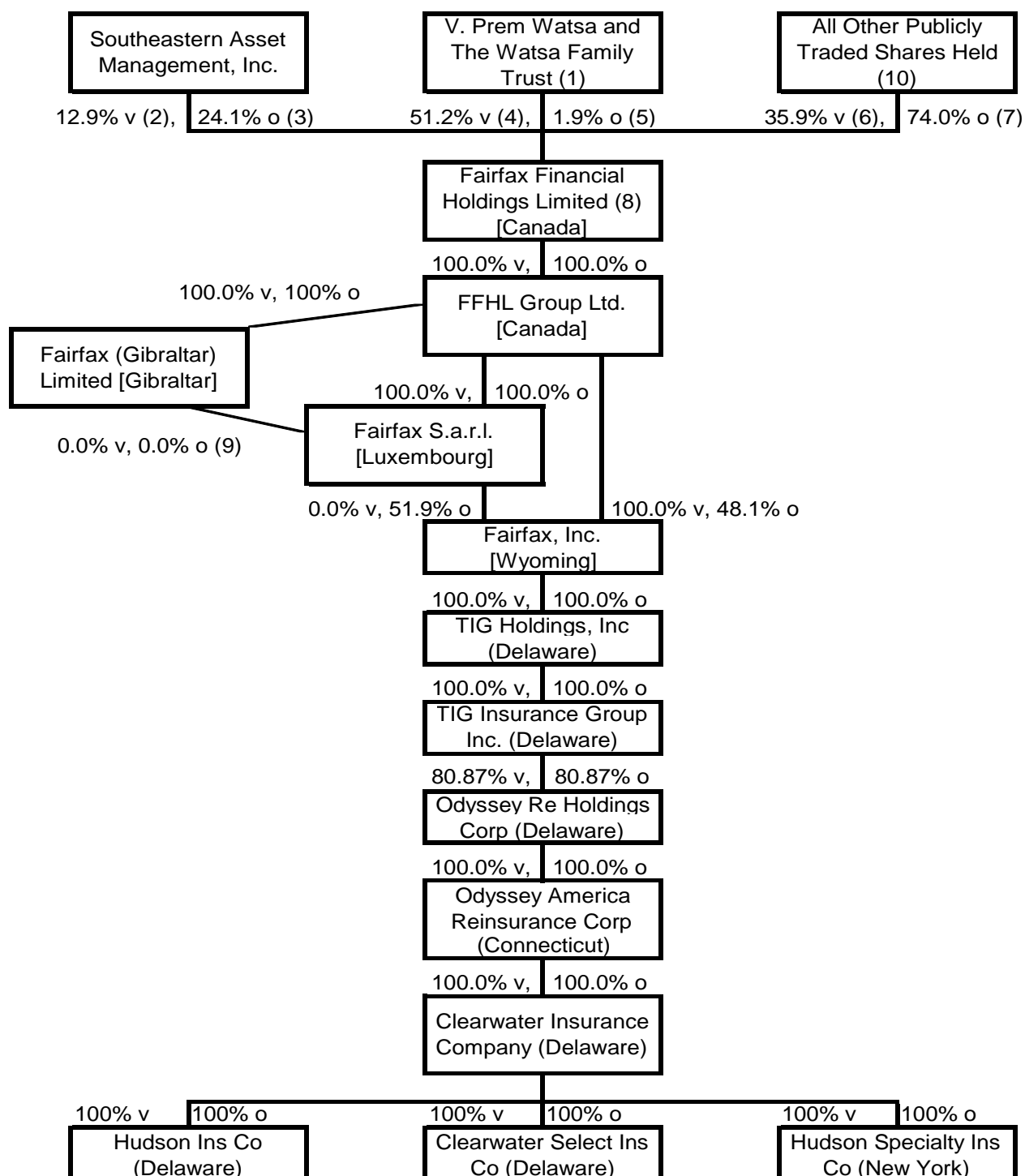
| <u>Officer</u> | <u>Title</u> |
|--------------------------|---|
| Andrew A. Barnard | CEO |
| James E. Migliorini | President |
| Donald L. Smith | Sr Vice President, General Counsel & Corp Secretary |
| James B. Salvesen | Senior Vice President & Controller |
| Charles D. Troiano | Executive Vice President & COO |
| Robert S. Bennett | Executive Vice President & Chief Actuary |
| Christopher L. Gallagher | Executive Vice President |
| Mark W. Hinkley | Executive Vice President |
| Brian D. Quinn | Executive Vice President |
| Michael G. Wacek | Executive Vice President |
| Brian D. Young | Executive Vice President |
| Seymour L. Andrew | Senior Vice President |
| Thomas D. Corteville | Senior Vice President |
| Gerard A. Dugan | Senior Vice President |
| Patrick E. Gentile | Senior Vice President |
| Joseph A. Guardo | Senior Vice President |
| Anthony J. Narciso Jr. | Senior Vice President & CFO |
| Jeffrey M. Rubin | Senior Vice President |
| Christopher T. Suarez | Senior Vice President |

INSURANCE HOLDING COMPANY SYSTEM

The Company is a member of an Insurance Holding Company System under the ultimate parent company, Fairfax Financial Holdings Limited (Fairfax) a Canadian Company. Fairfax is traded on the Toronto and New York stock exchanges under the ticker symbol "FFH". Fairfax conducts insurance and reinsurance business globally in all segments of the property/casualty industries. At December 31, 2004, Fairfax owned 80.87% of Odyssey Re Holdings Corp., a publicly traded (NYSE – 'ORH') Delaware holding company that indirectly owns 100% of Clearwater.

Clearwater Insurance Company

The following chart, of which Clearwater Insurance Company, is part identifies the relationships between its parent, affiliates and subsidiaries as of December 31, 2004.



v = voting control
o = ownership control

- (1) through voting and ownership control, both directly and indirectly, of the following individual and entities: Mr. V. Prem Watsa, 1109519 Ontario Limited, 810679 Ontario Limited and The Sixty Two Investment Company Limited
- (2) calculated as 3,974,780 votes (3,974,780 subordinate common shares held) divided by 30,822,759 votes [See (8)]
- (3) calculated as 3,974,780 subordinate common shares held / 15,342,759 total subordinate common shares times \$1,781,800,000 / \$1,918,400,000 [See (8)]
- (4) calculated as 0.8% through V. Prem Watsa and 50.4% through The Watsa Family Trust and the three entities described in (1). The 0.8% is calculated as 159,735 subordinate voting common shares (159,735 votes) through 810679 Ontario Limited and 96,568 subordinate voting common shares (96,568 votes) held personally by Mr. V. Prem Watsa, which equals 256,303 votes divided by 30,822,759 total votes. The 50.4% is calculated as 50,620 subordinate voting common shares (50,620 votes) plus 1,548,000 multiple voting common shares (15,480,000 votes) held through The Watsa Family Trust, 1109519 Ontario Limited and The Sixty Two Investment Company, which equals 15,530,620 votes divided by 30,822,750 total votes. [See (8)]
- (5) calculated as 306,923 subordinate common shares held (256,303 plus 50,620 [See (4)]) / 15,342,759 total subordinate voting common shares times \$1,781,800,000 / \$1,918,400,000 [See (8)]
- (6) 100.0% minus 12.9% (2) minus 51.2% (4)
- (7) 100.0% minus 24.1% (3) minus 1.9% (5)
- (8) common shares are publicly traded on the Toronto Stock Exchange in Canada and the New York Stock Exchange in the U.S. under the symbol "FFH". The Company has issued at 12/31/04 1,548,000 multiple voting common shares (which carry ten votes per share), 15,342,759 subordinate voting common shares (which carry one vote per share) and 8,000,000 non-voting preferred Series A shares. Total votes then consist of the 15,480,000 votes attributable to the multiple voting common shares and 15,342,759 votes attributable to the subordinate voting common shares or a total of 30,822,759 votes in all. Fairfax's capital account at 12/31/04 totals \$1,918,400,000 (U.S.) which consists of common shares totaling \$1,781,800,000 (92.9% of the total) and preferred shares totaling \$136,600,000 (7.1% of the total).
- (9) 0% ownership and 0% voting control but entity holds non-voting preferred shares issued by Fairfax S.a.r.l.
- (10) Other than Southeastern Management, Inc. [see (2) and (3)], no other entity or individual owns or controls greater than 10% as of 12/31/04, but as of 3/31/05, Goldman Sachs owned 1,800,176 subordinate voting common shares, which represented 5.8% voting control (1,800,176 divided by 30,822,750 total votes) and 10.9% ownership control (1,800,176 divided by 15,342,759 times \$1,781,800,000 divided by \$1,918,400,000).

It was noted during our review that the Company's filed annual statement did not reflect the proper ownership percentages. Subsequent to the examination the error regarding ownership percentages was corrected. Voting percentages, however remain undisclosed, and should be disclosed on the holding company chart. Therefore,

It is recommended that the Company properly disclose the Holding Company voting structure in the filed Annual statement (refer to summary of recommendations).

It was observed that Southeastern Asset Management, Inc had filed and received a disclaimer of control and exemption under Section 5003 (e) (2) regarding control of greater than 10% of the securities of FFH. This filing was accepted by the Delaware Department of Insurance on November 22, 2004. Southeastern Asset Management, Inc was identified in the 2004 Holding Company Registration Statement as controlling more than 10% of the voting stock of FFH [statement claimed 25% but actual was 12.9% voting control and 24.1% ownership control]. V. Prem Watsa, who had 51.2% voting control of FFH and 1.9% ownership control of FFH, was identified in the holding company registration statements for the years under examination as the “Chairman” of the ultimate controlling entity FFH. In addition, another entity, Goldman Sachs, had amassed 5.8% voting control of FFH and 10.9% ownership control of FFH during the first quarter 2005.

GROWTH OF COMPANY

The following information was obtained from the Company’s filed Annual Statements and covers the period from the prior examination to December 31, 2004, and reflects changes made for the current examination:

Clearwater Insurance Company

| <u>Year</u> | <u>Net Written Premiums</u> | <u>Net Admitted Assets</u> | <u>Liabilities</u> | <u>Surplus as Regards Policyholders</u> | <u>Net Income</u> |
|-------------|-------------------------------------|------------------------------------|--------------------|---|-----------------------|
| 2002* | \$18,649,129 | \$1,041,896,000 | \$607,988,628 | \$433,907,372 | (\$4,729,398) |
| 2003 | 5,476,711 | 1,005,690,932 | 448,648,360 | 557,042,572 | (22,739,759) |
| 2004* | 15,416,976 | 1,102,497,699 | 519,090,511 | 583,407,188 | (52,052,374) |

* Amounts per examination

The growth of the Company can be explained as follows:

- Net premiums written reflect Company not renewing any reinsurance business and starting to write direct business in 2004.
- Assets have maintained due to surplus contributions by parent.
- Liabilities have maintained at a constant level due to loss reserves increasing.
- Surplus has increased due to contributions by parent.
- Net Income reflects the adverse loss development over the past 2 years.

The above chart reflects the activity in the Company during the past two years resulting from capital contributions made by parent, change from a focus on being a reinsurer to a direct writer, and the unusually high adverse loss development.

TERRITORY AND PLAN OF OPERATION

Territory:

The Company is licensed to transact business in the following states, territories, possessions etc.:

| | | |
|-------------|-------------|----------------|
| Alabama | Kansas | Ohio |
| Alaska | Kentucky | Oklahoma |
| Arizona | Louisiana | Oregon |
| Arkansas | Michigan | Pennsylvania |
| California | Mississippi | Rhode Island |
| Connecticut | Montana | South Carolina |

Clearwater Insurance Company

| | | |
|----------------------|----------------|---------------|
| Delaware | Nebraska | Tennessee |
| District of Columbia | Nevada | Texas |
| Georgia | New Hampshire | Utah |
| Idaho | New Jersey | Virginia |
| Illinois | New York | Washington |
| Indiana | North Carolina | West Virginia |
| Iowa | North Dakota | Wisconsin |
| | | Puerto Rico |

The Company wrote 100% of its direct business in Tennessee.

Plan of Operation

Prior to 1999 the Company operated as a reinsurer. Starting in 1999 the Company did not enter into any new assumed business. As part of the marketing strategy for the Odyssey Re Holdings Corp. (ORH), the reinsurance business was shifted to another entity in the group and Clearwater became a direct writer.

The ORH Group provides a full range of property and casualty products on a world wide basis. Clearwater and Hudson Insurance Company are the primary vehicles through which ORH writes direct business. Clearwater operates as an admitted carrier.

The Company participates in Program business written through specialized general agents. These contracted agents write on Company paper business that meets its underwriting guidelines.

Program Business:

As at December 31, 2004 the Company only participated in one program which is shown in the table below:

Clearwater Insurance Company

| <u>Program</u> | <u>Gross Prem Written</u> | <u>Coverage</u> | <u>Territory</u> |
|----------------|-------------------------------|-----------------|------------------|
| TIS | \$12,655,000 | Commercial Auto | TN |

INTERCOMPANY MANAGEMENT AND EXPENSE SHARING AGREEMENTS

Expense Sharing Agreement

As of January 1, 2000 Fairfax Inc., Odyssey America Reinsurance Corporation, Clearwater and Hudson Insurance Company entered into an expense sharing agreement. The agreement called for each company to make available to the other companies management underwriting, claims, accounting, financial, legal, personnel, data processing services and consulting, to be used at times and in amounts determined necessary or appropriate by the managing officers of each Company.

Tax Allocation Agreement

Effective June 19, 2001, Fairfax Inc., Odyssey Re Holdings Corp., Odyssey America Reinsurance Corp., Clearwater, Hudson, Clearwater Select Insurance Company and Hudson Specialty Insurance Company entered into a tax allocation agreement. Under the agreement the affiliated group exercises the privileges granted under Section 1501 of the Code to file a consolidated return. Each company's tax liability is calculated based upon its respective share of consolidated income. The agreement further provides that each member shall receive reimbursement to the extent that their losses and other credits result in a reduction of the current year's consolidated tax liability, not to exceed their liability as if filed on an individual basis.

Investment Management Agreement

The Company entered into an investment agreement with Hamblin Watsa Investment Counsel Ltd and Fairfax Financial Holdings Limited effective January 1, 2003. The agreement calls for Hamblin Watsa Investment Counsel to manage on a continuous basis the Company's

Clearwater Insurance Company

investment account in accordance with the investment objectives communicated in writing by Management.

REINSURANCE

Schedule F part 1 was reviewed for the period 2003 through 2004. The Company did not write any direct business in 2003. Direct business written in 2004 was \$12.7 million.

A schedule of the Company's premiums follows:

| | | |
|-------------------|------------------|---------------------|
| Direct | | \$12,655,193 |
| Assumed: | | |
| Affiliates | \$ 266,483 | |
| Non-Affiliates | <u>2,333,301</u> | |
| Total Assumed | | 2,599,784 |
| Ceded: | | |
| Affiliates | \$ (59,221) | |
| Non-Affiliates | <u>(102,778)</u> | |
| Total Ceded | | <u>(161,999)</u> |
| Total Net Premium | | <u>\$15,416,976</u> |

Assumed Reinsurance - Affiliates

The Company assumes business from various affiliates, with Clearwater Select Insurance Company ("Clearwater Select") accounting for 75 percent of it in 2004. The Company replaced Overseas Partners Re Limited, Clearwater Select's former parent company, as 75% reinsurer of Clearwater Select. This agreement was effective November 15, 2004 and was approved by the Delaware Department of Insurance on October 26, 2004.

Assumed Reinsurance - Non-Affiliates

The Company was primarily a reinsurer until 2004, when it began writing direct business. As such, it had only assumed business until 2003 with no new treaties entered into since 1999.

Clearwater Insurance Company

Current assumed business is from assumption agreements, which were effective prior to 1999 and are currently in run-off.

Ceded Reinsurance

The following significant reinsurance covers were available to the company:

Casualty

- Casualty Facultative per risk excess of loss (ref #9394)- 2000 underwriting year only
 - Section A - Non Canadian, \$4,000,000 xs \$1,000,000, any one occurrence each risk
 - Section B - Canadian, CDN\$8,000,000 xs CDN\$2,000,000, any occurrence each risk

Property

Clearwater is a named reinsured on the Odyssey America 2000-2002 Property Catastrophe Excess of Loss covers. The below illustrates these covers.

For 2000, the layers of these covers are as follows:

- \$10,000,000 xs \$10,000,000, per occurrence, 100% placed with reinsurers (TR173)
- \$10,000,000 xs \$20,000,000, per occurrence, 95% place with reinsurers (TR180)
- \$10,000,000 xs \$30,000,000, per occurrence, 95% placed with reinsurers (TR181)
- \$80,000,000 xs \$20,000,000, per occurrence, 20% placed with reinsurers (TR191)
- \$50,000,000 xs \$50,000,000, per occurrence, 50% placed with reinsurers (TR195)

Property Cat - (TR199)

- Section A - Property - \$15,000,000 xs \$5,000,000per occurrence (2 loss max)
- Section B - Marine, aviation, satellite - \$10,000,000 xs \$2,500,000
- Section C - Satellite - \$10,000,000 xs \$1,000,000 in the aggregate
- Section D - Latin America business - \$2,500,000 xs \$2,500,000

For 2001, the layers of these covers are as follows:

- \$10,000,000 xs \$10,000,000, per occurrence, 100% placed with reinsurers (TR173)
- \$10,000,000 xs \$20,000,000, per occurrence, 60% place with reinsurers (TR217)
- \$10,000,000 xs \$30,000,000, per occurrence, 60.0% placed with reinsurers (TR218)
- \$10,000,000 xs \$40,000,000, per occurrence, 60% placed with reinsurers (TR219)
- \$10,000,000 xs \$30,000,000, per occurrence, 20.0% placed with reinsurers (TR227)
- \$80,000,000 xs \$20,000,000, per occurrence, 20% placed with reinsurers (TR191)
- \$60,000,000 xs \$40,000,000, per occurrence, 20% placed with reinsurers (TR224)
- \$50,000,000 xs \$50,000,000, per occurrence, 50% placed with reinsurers (TR195)

Property Cat - (TR199)

- Section A - Property - \$15,000,000 xs \$5,000,000per occurrence (2 loss max)
- Section B - Marine, aviation, satellite - \$10,000,000 xs \$2,500,000
- Section C - Satellite - \$10,000,000 xs \$1,000,000 in the aggregate
- Section D - Latin America business - \$2,500,000 xs \$2,500,000

For 2002, the layers of these covers are as follows:

- \$10,000,000 xs \$10,000,000, per occurrence, 100% placed with reinsurers (TR173)
- \$20,000,000 xs \$20,000,000, per occurrence, 25.75% place with reinsurers (TR248)
- \$20,000,000 xs \$30,000,000, per occurrence, 50.0% placed with reinsurers (TR253)
- \$70,000,000 xs \$40,000,000, per occurrence, 22.8572% placed with reins (TR191)
- \$60,000,000 xs \$40,000,000, per occurrence, 15.0% placed with reinsurers (TR224)
- \$50,000,000 xs \$50,000,000, per occurrence, 50% placed with reinsurers (TR195)

Property Cat - (TR199)

- Section A - Property - \$15,000,000 xs \$5,000,000 per occurrence (2 loss max)
- Section B - Marine, aviation, satellite - \$10,000,000 xs \$2,500,000
- Section C - Satellite - \$10,000,000 xs \$1,000,000 in the aggregate
- Section D - Latin America business - \$2,500,000 xs \$2,500,000

Clearwater Insurance Company is protected by a Stop Loss agreement for 1995 and prior business in connection with the sale of the Company to Fairfax Holdings. The Stop Loss has an aggregate limit of \$175 million and a calendar limit of \$17.5 million. The stop loss is net of existing reinsurance. The contract originally assumed by Skandia Insurance Company Ltd, was assumed by ORC Re Limited (Dublin), now known as nSpire Re, Limited, a Fairfax wholly owned subsidiary. In 2000 the Company received permission from the Delaware Insurance Department to remove the annual aggregate limit of \$17,500,000 on the 1995 stop-loss agreement. As of year-end 2004, there was \$17.5 million of limit remaining on the cover.

ACCOUNTS AND RECORDS

The accounts and records reviewed included an evaluation of the Company's operation and organization controls. The areas evaluated included computer systems, accounting systems, organization structure and the processing structure. The Company operates in a computer dominated environment. The records of the Company are kept by an affiliate Odyssey America Reinsurance Corp. per an expense sharing agreement. The companies use the "Great Plains" software for the general ledger application. The Great Plains software consists of multiple modules including Fixed Assets, Accounts Payable and Integration Management as well as other financial reports including a trial balance report that is utilized by the Company.

A review of the Company's computer environment indicated the following deficiencies:

- The Company does not update and distribute RSG application documentation following enhancements or modifications to application controls. RSG users and application support staff may not be aware of all the enhancements and modifications to the application, which may impact system availability and the productivity of the user groups.

It is recommended that the Company institute effective policies and procedures to ensure that all documentation associated with the RSG application is updated following any changes to the application. It is also recommended that a distribution process be initiated to ensure that all users have access to the latest revision of application documentation following any enhancements or modifications.

- The Company does not have formally documented standards or operations procedures manual. Comprehensive documentation is critical to upholding high standards for quality and performance and reducing the cost of system and programming maintenance. These controls help ensure that accurate and relevant documentation is prepared for all new systems and for changes to existing systems and/or programs. Maintaining comprehensive documentation is critical to maintaining standards and quality and the documentation should be continuously reviewed to ensure that it is up to date and accurate.

It is recommended the Company formally develop a standard operations procedure manual. The manual should contain standard procedures for IT operations, to include all network operations. All IT solutions and platforms in place should be operated using these procedures. In addition, the procedures manual should be reviewed periodically to ensure effectiveness and adherence.

- The Company does not have a formal computer maintenance schedule and therefore runs the risk of diminished performance and reliability of computer systems.

It is recommended that the Company develop a schedule of planned computer maintenance to help protect its information technology investment and to reduce the risk of downtime.

- The Company has not documented its system software selection and option review procedures. Without adequate system software selection and option review procedures, the risk of implementing system software that does not meet the Company's needs is increased. In addition, the risk of implementing system software that was not adequately tested or reviewed before being moved into the live environment increased. This could result in delays in identifying and correcting production problems or operational failures.

It is recommended the Company develops and document system software selection and options review procedures for reference and to ensure standard procedures are used to identify, select, program, test, implement

and control system software. These procedures should include written management approval and appropriate standards regarding test procedures.

- The Company has not documented procedures for network infrastructure changes. Without a documentation procedure, changes to the network infrastructure could be made without fully being aware of the impact to the applications, systems and network. Also, changes to the network could be made without proper or adequate preparation, resulting in system outages or reduced functionality.

It is recommended that the Company document the procedures for making any network infrastructure changes. This will ensure that all changes that need to be made are reviewed and approved by appropriate management. This should also provide consistent analysis for each change or upgrade, and require that proper operational impact studies be made.

- The Company does not have formal emergency response procedures to follow if a computer security incident occurs. Without adequate security response procedures, there is an increased risk of gradual or sudden degradation of Company systems or the risk of misappropriation of Company funds or the risk of confidential information being made public.

It is recommended the Company develop formal emergency response procedures to follow if a computer security incident occurs. These procedures should be communicated to all employees and contain specific instructions for employees to follow if a computer security incident occurs.

- As part of the review of Cash and Cash related items an inquiry was made to the Company regarding its procedures for escheating monies to States. The Company disclosed that they do not have a procedure in place at the present time but one is being developed and will be put in place as soon as possible.

It is recommended that the Company complete the development of the process to escheat funds to the States as soon as possible. The Company's implementation should include procedures for handling outstanding checks.

FINANCIAL STATEMENTS

The following financial statements as determined by this examination are presented herein:

Analysis of Assets as of December 31, 2004

Liabilities, Surplus and Other Funds As of December 31, 2004

Underwriting and Investment Exhibit – Statement of Income For the Year Ended
December 31, 2004

Capital and Surplus Account for the one year period ended December 31, 2004

Examination Changes

Clearwater Insurance Company

Analysis of Assets

As of December 31, 2004

| | <u>Assets</u> | <u>Nonadmitted Assets</u> | <u>Net Admitted Assets</u> | <u>Note</u> |
|--|-------------------------|-------------------------------|------------------------------------|-------------|
| Bonds | \$ 260,020,341 | \$ 6,798,874 | \$ 253,221,467 | 1 |
| Common stocks | 534,503,128 | | 534,503,128 | 2 |
| Cash, cash equivalents and short term investments | 143,138,058 | | 143,138,058 | |
| Other invested assets | 60,133,634 | | 60,133,634 | |
| Receivable for securities | 806,281 | | 806,281 | |
| Aggregate write-ins for invested assets | 7,231,917 | | 7,231,917 | |
| Investment income due and accrued | 3,148,284 | | 3,148,284 | |
| Premiums and considerations: | | | | |
| Uncollected premiums and agents' balances in the course of collection | 3,468,948 | 1,101,940 | 2,367,008 | |
| Deferred premiums, agents' balances and installments booked but deferred and not yet due | (144,102) | | (144,102) | |
| Accrued retrospective premium | 2,880,600 | 288,060 | 2,592,540 | |
| Reinsurance: | | | | |
| Amounts recoverable from reinsurers | 71,001,903 | | 71,001,903 | |
| Funds held by or deposited with reinsured companies. | 7,550,026 | | 7,550,026 | |
| Current federal and foreign income tax recoverable and interest thereon | 5,205,328 | 5,205,328 | - | |
| Net deferred tax asset | 4,974,046 | | 4,974,046 | |
| Furniture and equipment, including healthcare delivery assets | 65,846 | 65,846 | - | |
| Receivable from parent, subsidiaries and affiliates | 11,973,509 | | 11,973,509 | |
| Other assets nonadmitted | 594,635 | 594,635 | | |
| Totals | <u>\$ 1,116,552,382</u> | <u>\$ 14,054,683</u> | <u>\$ 1,102,497,699</u> | |

Liabilities, Surplus and Other Funds

| | | <u>Note</u> |
|---|-------------------------|-------------|
| Losses | \$ 416,603,617 | 3 |
| Reinsurance payable on paid loss and loss adjustment expenses | 2,996,292 | |
| Loss adjustment expenses | 3,168,810 | 3 |
| Commissions payable, contingent commissions and other similar charges | (831,900) | |
| Other expenses | 20,815,741 | |
| Taxes, licenses and fees | 316,380 | |
| Current federal and foreign income taxes | 2,964,336 | |
| Unearned premiums | 549,122 | |
| Ceded reinsurance premiums payable | 1,365,916 | |
| Funds held by company under reinsurance treaties | 15,826,343 | |
| Amounts withheld or retained by company for account of others | (12,798) | |
| Provision for reinsurance | 49,417,486 | |
| Drafts outstanding | 8,815 | |
| Payable to parent, subsidiaries and affiliates | 5,902,351 | |
| | <u>\$ 519,090,511</u> | |
| Common capital stock | 7,500,000 | |
| Gross paid in and contributed surplus | 359,595,676 | |
| Unassigned funds (surplus) | 216,311,512 | |
| Surplus as regards policyholders | <u>\$ 583,407,188</u> | |
| Total | <u>\$ 1,102,497,699</u> | |

Underwriting and Investment Exhibit: Statement of Income

For the Year Ended December 31, 2004

Note

| | |
|---|------------------|
| <u>Underwriting Income</u> | |
| Premiums earned | \$ 15,483,584 |
| Deductions: | |
| Losses incurred | \$ 117,159,580 |
| Loss expenses incurred | 13,532,307 |
| Other underwriting expenses incurred | 5,656,238 |
| Total underwriting deductions | \$ 136,348,125 |
| Net underwriting gain or (loss) | \$ (120,864,541) |
| <u>Investment Income</u> | |
| Net investment earned | \$ 25,440,947 |
| Net realized capital gains or (losses) | 41,643,790 |
| Net investment gain (loss) | \$ 67,084,737 |
| <u>Other Income</u> | |
| Aggregate write-in for aggregate income | \$ (1,842) |
| Net income before federal income taxes | \$ (53,781,646) |
| Federal and foreign income taxes | (1,729,272) |
| Net income | \$ (52,052,374) |
| <u>Capital and Surplus Account</u> | |
| Surplus as regards policyholders December 31, 2003 | \$ 557,042,572 |
| Net income | \$ (52,052,374) |
| Change in net unrealized capital gains or (losses) | 46,954,251 |
| Change in net unrealized foreign exchange capital gain (loss) | (3,165,336) |
| Change in net deferred income tax | (12,706,974) |
| Change in nonadmitted assets | (6,017,487) |
| Change in provision for reinsurance | (7,058,655) |
| Surplus adjustments: | |
| Paid in | 60,411,191 |
| Change in surplus as regards policyholders for the year | \$ 26,364,616 |
| Surplus as regards policyholders, December 31, 2004 | \$ 583,407,188 |

Examination Adjustments

No examination adjustments were made of a result of this examination.

NOTES TO THE FINANCIAL STATEMENTS

Note 1

Bonds \$253,221,467

Investments in bonds are reported at values (amortized cost) adopted and approved by the Securities Valuation Office (SVO) of the NAIC. Bonds owned by the Company are as follows:

| | |
|--|----------------------|
| US Government | \$141,423,272 |
| States, territories and possessions | 540,769 |
| Special revenue | 515,879 |
| Industrial and miscellaneous | 83,799,719 |
| Industrial and miscellaneous other countries | 9,441,828 |
| Parent, subsidiaries and affiliates | 17,500,000 |
| Total | <u>\$253,221,467</u> |

Bonds are designated by the SVO with the highest quality being “1” and lowest being “6”. The bond designations are as follows:

| | |
|---|----------------------|
| 1 | \$ 225,738,870 |
| 2 | 540,769 |
| 3 | 17,500,000 |
| 6 | 9,441,828 |
| | <u>\$253,221,467</u> |

Clearwater Insurance Company

Bonds with carrying values of \$27,548,837 were on deposit with various states, governmental insurance departments or as collateral in compliance with insurance laws.

The Company did not have any securities on loan.

Note 2

Common Stocks \$534,503,128

Affiliated common stock investments of \$410,981,960 represent 77% of the total. The largest single common stock investment is in Hudson Insurance Company for \$79,076,284 or 15%. The Company owns in excess of 10% of the outstanding shares of the following Companies:

| | | |
|-------------------------------------|-------|---------------|
| Hudson Insurance Company | 100% | \$ 79,076,284 |
| Hudson Specialty Insurance Company | 100% | 68,042,280 |
| Clearwater Select Insurance Company | 100% | 61,837,429 |
| TRG Holding Corporation | 13% | 77,877,377 |
| HUB International Limited Common | 13.6% | 69,697,679 |
| HWIC Asia Fund Common Stock Class A | 10.4% | 43,610,896 |

The above securities were valued in accordance with the Purposes and Procedures Manual of the NAIC Securities Valuation Office and the Delaware Department of Insurance.

Note 3

Loss Reserves \$416,603,617
Loss Adjustment Expense Reserves 3,168,810

Loss and loss adjustment expense reserves represent 80.9% of the Company's liabilities as of December 31, 2004. Incurred but not reported reserves (IBNR) constituted 32.6% of loss reserves at year-end 2004.

INS Consultants, Inc. (INS) was retained by the Delaware Insurance Department to conduct a review of the Company's reserve methodologies and adequacy. INS evaluated the Company's book of business by line of business for loss and allocated loss adjustment expenses. The conclusions reached by INS are largely based upon information supplied by the Company's staff, which included an in-depth actuarial analysis. The INS reserve analysis was performed on both a gross and net basis of reinsurance and did not address the collectibility of reinsurance recoverables. The INS reserve review found the Company's combined net loss and loss adjustment expense reserves were adequate to support the business underwritten.

The underlying data was tested through a review of open and paid claim files and actual payments made with no exceptions noted. The aggregated actuarial data provided by the Company was verified and reconciled to Schedule P of the Company's filed annual statement.

Loss and LAE reserves are subject to errors of estimation arising from the fact that the ultimate liability for claims evaluated as of the valuation date are dependent on future contingent events which cannot always be anticipated. The possible occurrence of such events, as well as the inherent uncertainty associated with statistical estimates, allows no guarantee that the actual ultimate liabilities will be the same as the reserve levels described in this examination report. As a result of this study, the reserves were accepted.

COMPLIANCE WITH PRIOR RECOMMENDATIONS

The prior examination report recommended that the Company report certain disputed over due balances recoverable from its former parent for Federal Income Taxes as a non-admitted asset. The Company has complied with the recommendation.

SUMMARY OF RECOMMENDATIONS

It is recommended that the Company properly disclose the Holding Company voting structure in the filed Annual statement. Page 9

It is recommended that the Company institute effective policies and procedures to ensure that all documentation associated with the RSG application is updated following any changes to the application. It is also recommended that a distribution process be initiated to ensure that all users have access to the latest revision of application documentation following any enhancements or modifications. Page 16

It is recommended the Company formally develop a standard operations procedure manual. The manual should contain standard procedures for IT operations, to include all network operations. All IT solutions and platforms in place should be operated using these procedures. In addition, the procedures manual should be reviewed periodically to ensure effectiveness and adherence. Page 17

It is recommended that the Company develop a schedule of planned computer maintenance to help protect its information technology investment and to reduce the risk of downtime. Page 17

It is recommended the Company develops and documents system software selection and options review procedures for reference and to ensure standard procedures are used to identify, select, program, test, implement and control system software. These procedures should include written management approval and appropriate standards regarding test procedures. Page 17

It is recommended that the Company document the procedures for making any network infrastructure changes. This will ensure that all changes that need to be made are reviewed and approved by appropriate management. This should also provide consistent analysis for each change or upgrade, and require that proper operational impact studies be made. Page 18

It is recommended the Company develop formal emergency response procedures to follow if a computer security incident occurs. These procedures should be communicated to all employees and contain specific instructions for employees to follow if a computer security incident occurs. Page 18

It is recommended that the Company complete the development of the process to escheat funds to the States as soon as possible. The Company's implementation should include procedures for handling outstanding checks. Page 18

CONCLUSION

As a result of this examination, the financial condition of the Clearwater Insurance Company, as of December 31, 2004, was determined as follows:

| | 12/31/04 | 12/31/02 | Changes |
|--|-------------------------|------------------------|---------------------|
| | Current | Prior | Increase |
| <u>Description</u> | <u>Examination</u> | <u>Examination</u> | <u>(Decrease)</u> |
| Assets | \$ 1,102,497,699 | \$ 1,041,896,000 | \$60,601,699 |
| Liabilities | 519,090,511 | 607,988,628 | (88,898,117) |
| Common capital stock | 7,500,000 | 7,500,000 | 0 |
| Gross Paid in and contributed capital | 359,595,676 | 254,091,672 | 105,504,004 |
| Unassigned funds (surplus) | 216,311,512 | 172,315,700 | 43,995,812 |
| Total surplus as regards policyholders | 583,407,188 | 433,907,372 | 149,499,816 |
| Totals | <u>\$ 1,102,497,699</u> | <u>\$1,041,896,000</u> | <u>\$60,601,699</u> |

Since the last examination, the Company's assets have increased \$60,601,699, liabilities have decreased \$ 88,898,117 and capital and surplus increased \$149,499,816. In addition to the undersigned, acknowledgement is made of the assistance provided by the Delaware Insurance Department, INS Consultants Inc. and INS Insurance Services.

Respectfully submitted,



Richard Randour, CFE
Examiner In-Charge
State of Delaware

SUBSEQUENT EVENT

As summarized in Note 25: Change in Incurred Losses and Loss Adjustment Expenses in the 2005 Annual Statement of the Clearwater Insurance Company: Included in the liability for unpaid losses and loss expenses in 2005 were \$120,139,000 incurred losses and loss expenses related to prior years.

Adverse loss emergence of United States casualty business written in the period 1997 through 2001 is the principal cause of the significant incurred loss and loss expense related to prior years for both calendar year 2005 and 2004. During the latest two calendar years the Company increased loss estimates for these exposures based on additional information becoming available to the Company in calendar years 2005 and 2004.